An Overview of the European Repo Market

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Secured funding has become a critical tool since the crisis

A repurchase agreement (repo) is the sale of securities together with an agreement for the seller to buy back the securities at a later date. The repurchase price is generally higher than the sale price, with the difference representing interest. As such, a repo is economically similar to a secured loan, with the buyer receiving securities as collateral to protect himself against default by the seller. Unlike a secured loan however, legal title to the securities passes from the seller to the buyer. A reverse repo is simply the same repurchase agreement from the buyer’s viewpoint.

The Repo product has become more and more pivotal for liquidity management as the world gravitates away from unsecured funding post the 2008 crisis. SIFMA estimate current daily turnover in the US market to be in the region of €4tn. In a similar study by ICMA, they estimate outstanding balances on any given day in the European market to account for €5.8tn. In addition, repo’s are widely used by central banks to increase or decrease liquidity in the market. The estimated total market may be as large as €15tn. Repos can be though of as the grease that oils the wheels in the financial markets, with any decrease in repo activity usually leading to reduced liquidity, slower settlement and larger bid-offer spreads.

The Repo desk at BNPP contains 27 traders globally (20 Rates/7 Credit) based in London, New York, Brussels, Tokyo & Singapore. The structure and function of Repo desks varies from bank to bank, but at BNPP, the desk is responsible for funding the Fixed Income’s long inventory and covering short positions as well as operating as market makers for all major Sovereign as well as supranational, agency and EM sovereign (SAS), covered and corporate debt. For simplicity, all high grade sovereign debt is classed as Rates repo, all SAS, covered and corporate bonds are part of Credit repo.
The Basics
Repos can be thought of as a secured loan

Imagine BNP Paribas borrow €100m cash from HSBC for 3 months and post French OAT bonds as collateral.

1) Today
BNP Paribas receives €100m in cash and posts €100m of French bonds as collateral.

2) Trade life
On a daily basis throughout the life of the trade, collateral management will value the collateral to ensure it is sufficient to cover the cash in the event of a default. If the value of the bonds increase, BNP Paribas’ collateral management team will request some bonds back from HSBC. If the value of the bonds has fallen, HSBC’s collateral management team will request that more bonds are posted. Although market standard is daily margin call, some platforms now allow intraday.

3) T+3 months
BNP Paribas repays the cash plus interest (€100m x 0.45% x (60/360)) in exchange for the French bonds.
Types of Repo

You can lend securities for cash, or for other securities

Type

- **Repo** - Repo involves lending bonds and borrowing cash on the initial leg and paying back the cash plus interest and receiving bonds back on the end leg. This is used by investors who need cash and have positions to fund.

- **Reverse Repo** - The opposite of above, whereby we receive interest for lending cash. This is used by investors who are long cash and are looking to invest or by those who have shorted a bond and need to cover that position.

- **Collateral exchange** - Also know as a collateral upgrade trade whereby you lend bonds and receive different bonds e.g. give Bunds, receive OATs. Typically the person giving the lowest quality collateral will also pay a fee. This is used by investors who need higher quality assets to post as collateral or somebody who needs to fund lower grade collateral. A collateral upgrade would trade would occur when we post lower level collateral than that which we receive, i.e. we have upgraded our securities holding. A collateral downgrade trade is the opposite. As collateral exchanges are security vs security, they do not appear on the balance sheet of either counterpart.

Trade Type

- **Bilateral** - A direct trade between two counterparties. Margined according to the standard documentation.

- **Cleared** - A trade made with a Central Clearing Counterparty (CCP) which sits in the middle of transactions, becoming the buyer to every seller, and the seller to every buyer. The CCP is highly rated because it manages risk by charging margin and haircuts to all counterparties and has significant default funds and other safeguards, thereby reducing risk for members. This is considered to be the safest way to trade repo.

- **Tri-party** - Somewhere between Bilateral and Cleared repo, whereby much of the post trade processing such as collateral selection, payment, settlement custody and management is outsources to a 3rd party agent. The main 3rd party agents are Clearstream, Euroclear, Bank of New York and JP Morgan. Because the tri-party agent is just an agent, use of this service does not change the relationship between the parties as the agent does not participate in the risk of the transaction. Tri-party repo does not provide a platform to trade and so once the parties have agreed the deal bilaterally, they will notify the tri-party agent who matches the instructions.
Collateral is generally split between Rates and Credit

Ideally, collateral should be free of credit and liquidity risk. The market value of such an asset would be certain, and it would be easy to liquidate in the event of a default. In practice, such an asset doesn’t exist, with the closest asset to this paradigm a high grade sovereign bond such as the Bund or a US Treasury.

Government bond repo accounts for around 80% of the European repo market, with US Treasuries accounting for nearly 70% of the US market. Government bonds, Government sponsored Agency and Supranational debt is traded within Rates Repo. Everything else is considered Credit repo.

Rates Repo

- High grade sovereign debt such as that of the US, Germany, UK or France
- Agency bonds such Fannie Mae, Freddie Mac and Ginnie Mae
- Supranational bonds such as the ECB. These are on the cusp between Credit and Rates repo

Credit Repo

- High yield, emerging market sovereign bonds such as Brazil or Poland
- Government guaranteed bonds such as municipal bonds for various states in the US
- Covered bonds which are secured by pools of public loans or mortgages held by the issuer
- ABS such as mortgage backed securities or credit card receivables
- Corporate bonds, typically senior unsecured debt issued by investment grade banks and non-financial companies
General Collateral vs Special Collateral

Collateral is also split between GC and Special

General Collateral

General Collateral or “GC” is the name used for range of assets that are accepted, at any particular moment, as collateral in the repo market by the majority of market intermediaries and at a very similar repo rate - the GC repo rate. In other words, the market as a whole is indifferent between general collateral. GC assets can be high quality and liquid, but not subject to exceptional demand. The GC repo rate should therefore be driven purely by the supply of and demand for cash (not by the supply of and demand for individual assets). As such, the GC repo rate should be closely correlated to other money market rates, although trading at a spread representing differences in credit and liquidity risks.

Investors tend to differentiate between the credit of issuers in core and peripheral Eurozone countries. There is consequently a German GC market, a French GC market and so on, but there is not a specific Eurozone GC market, the closest thing being Eurex Euro GC pooling.

Special Collateral

Unlike GC, Special collateral has specific value in the repo market. This value is generally created when a number of market participants are short the bond and therefore need to borrow it in the repo market on a daily basis. If the market level of shorts is sufficient enough compared to market volumes, this can push up the cost of borrowing that specific bond making it significantly more expensive than an equivalent GC bond, and hence it become special. There is no threshold point at which a bonds becomes special, but bonds would generally be considered special when their rates strays more than 10bp from equivalent GC bonds.
Why use Repo?

Security, competitive rates and liquidity make repos attractive

- Because the lending of cash is secured with collateral, it makes it a safer transaction as they will become the legal owners in the event of default and can liquidate these assets to recover their money. The fact that such transactions are margined daily adds further protection. This level of security makes repos attractive to more risk averse cash rich investors.

- Repos allow buyers to invest cash for a customised period of time with a known return, which is unlike most other products. Open repos also provide the flexibility for cash lenders to leave their cash out on loan earning yield until they need it.

- There are a large number of participants in the repo market which ensures a high level of liquidity for the main underlyings. This liquidity ensures that repo rates are competitive and the repo market remains fluid with tight bid/offer spreads.

- Standard but flexible documentation:
  - **Global Master Repurchase Agreement (GMRA)** - standard agreement for repo transactions developed by ICMA. It is designed for European fixed income government bonds under English law. It is possible to apply the GMRA to other products/countries by signing additional documentation.
  - **Global Master Securities Lending Agreement (GMSLA)** - similar to the GMRA and typically used by our Securities Lending counterparties.
  - **Master Repo Agreement (MRA)** - as per the GMRA but focussed on US law.

- Central banks use repo to conduct routine monetary policy operations and to provide emergency liquidity to the economy in times of crisis. Repo mitigates their credit risk and links them to an active interbank market for easy distribution of liquidity.

- Repo allows dealers in the primary securities market to fund their bids at auctions and underwriting positions in syndicated bond issuances at a reasonable cost.

- In the secondary market, market makers need repo to fund their positions and build inventory or cover shorts where it has been exhausted.

- Take advantage of excess returns by lending bonds that are special. Special bonds are those in such high demand that cash lenders are willing to receive a rate lower than GC, and even negative in some cases.
Risks & Mitigation

Reduced risk vs unsecured funding as it is collateralised

Credit Risk

- Credit-risk mitigated to seller as collateralised which is generally uncorrelated to the seller
- Some residual credit risk from underlying asset, which may have lost some of its value since the onset of the transaction. This is mitigated by:
  - Over-collateralisation (haircuts) which can vary from 0.5% on short duration German government bonds to over 30% on long duration Portuguese government bonds. For Bilateral and TriParty trades, there are generally no haircuts paid or received, but this will depend on whether we are giving cash or bonds, the underlying collateral and the counterparty. For example, if we are giving Spanish bonds in TriParty, we may pay up to 5%, if we are receiving Turkish bonds from a Turkish bank, we can charge up to 25%. Our net haircut position has a direct effect on our unsecured funding usage.
  - Daily mark-to-market (MtM) margining is standard as part of GMRA/GMSLA/MRA legal agreements. Should collateral values fall, Collateral Management will call on our counterparty to post more bonds

Interest Rate Risk

- Interest rates (such as Eonia) are the main drivers of repo rates with funding for some underlyings being quoted as a spread
- There is a risk for longer dated repos that rates move and you are left funding a position at a rate that is too expensive or providing liquidity to a client at a rate that is too cheap
- Interest rate risk is mitigated by entering into an OIS trade or Euribor futures contracts to protect/hedge against such rate moves.
Reduced risk vs unsecured funding as it is collateralised

Gapping

- Gapping refers to the maturity mismatch between our assets and our liabilities. Typically, with a normal, upward sloping yield/repo curve, the rates for lending/borrowing for 1 year will be higher than for lending/borrowing for 1 week. This would allow a desk such as the repo desk to benefit from their ability to lend term and cover it by borrowing over short dates.

- Gapping risk occurs where you need to keep rolling you short term borrowings to fund your long term loans and for whatever reason, funding may become more difficult and you are unable to fund, leaving a funding gap

- To manage the risk involved with such a mis-match, Risk-IM and ALM-T have imposed stringent gapping limits to ensure that on any given day, the gap between the two is not so large that we would not be able to cover this from other funding sources. These limits cover all currencies and asset classes and are monitored daily by Risk-IM.
The Repo Market
Why is the repo market so important?

The repo market is pivotal to the efficient functioning of almost all financial markets with a wide range and fundamental use:

- **Efficient source of money market funding.** The repo market is able to provide secured, diversified cheaper funding for financial intermediaries which can lower the cost of financial services to investors and issuers. It can also provide more stable and liquid longer term financing than unsecured funding which has proved more resilient in times of market turbulence.

- **Ensures liquidity in secondary market debt.** Allows market makers to borrow bonds hedge long positions with shorts in bonds with similar a maturities and cover short positions by borrowing bonds. Without this facility, market makers would only be able to sell the bonds they held and would be unwilling to buy bonds they already had a sizeable position in. This not only reduces the risk for the market maker, but has a knock on effect on prices and spreads.

- **Broadening and stabilising the money market.** The collateralised nature of repo allows a wider range of borrowers and lenders into the wholesale money markets than just commercial banks. The resulting breadth and diversification creates a deeper and more robust market with reduced systemic risk. In a crisis, access to CCP cleared repos provides reliable access to longer term funding when compared to unsecured funding.

- **Facilitating central bank operations.** The repo market provides a ready-made collateral management framework without which central banks would not be able to implement monetary policy so efficiently under normal market conditions and act as lenders of last resort so swiftly during periods of market turbulence.

- **Preventing settlement failures.** Repo plays a critical role in supporting day-to-day operational efficiency of securities markets by allowing issues to be borrowed in order to ensure timely onward delivery. This is particularly pertinent in the European market where national barriers persistently inhibit efficient cross border clearing and settlement.

- **Permitting faster settlement times.** Borrowing securities is critical in allowing settlement periods to be shortened. Faster settlement leaves less time for delivery problems to be corrected and therefore requires an efficient source of securities borrowing to prevent delivery failures.
The Repo Market – Some Data

Who, what, where, when and how?

How large?
There are large repo markets in Europe, the US, Latin America and Japan, and rapidly emerging repo markets in China and a number of African countries. The ICMA’s semi-annual survey of the European repo market in June 2014 produced a figure of about €5.8tn in outstanding repo contracts for the survey. The Federal Reserve Bank of New York reported that the outstanding repo business of its primary dealers (who may account for as much as 90% of the US market) as €4tn. The ICMA Centre at Reading University has suggested that the global commercial market may be up to €15tn in size.

Who uses it?
Traditionally, the principal users of repo, on the sellers’ side of the market, have been securities market intermediaries (broker-dealers) and leveraged investors such as hedge funds seeking funding. On the buyers’ side, the traditional principal users have been cash-rich and often very risk-averse investors such as non-bank financial institutions (eg central banks investing foreign currency reserves, international financial institutions, some commercial banks and money market mutual funds) seeking secure investments. Since the crisis, because of higher risk aversion and regulatory pressure, repo has been attracting all commercial banks as well as a greater number of non-bank financials as such sovereign wealth funds, pension funds, insurance companies, endowments and corporate treasuries.

How long?
Traditionally, repos have been short-term instruments and the bulk of liquidity is still relatively short-term. The US repo market is mainly overnight, but the maturity distribution of the European market is longer and had been slowly lengthening. This was happening before the crisis that erupted in 2007 but has since slowed down, partly in response to excess liquidity in the market from Central Bank operations. The proportion of short-dated repos (terms of one month or less) have decreased from about 65% of outstanding repos to about 60%, while term repos (which means 3 months or longer) has grown in tandem. In addition, forward repos, which often start one or more months in the future, account for about 10% of the survey. Repo with only one day to maturity is around 20%. Open repos are those without a maturity date and may be terminated on any day in the future by either counterparty.
Who, what, where, when and how?

Which currencies?
In the US market, the cash currency is predominantly USD. It is a little more varied in Europe as seen below:

<table>
<thead>
<tr>
<th></th>
<th>main survey</th>
<th>ATS</th>
<th>tri-party</th>
<th>WMBA</th>
</tr>
</thead>
<tbody>
<tr>
<td>EUR</td>
<td>65.7%</td>
<td>96.8%</td>
<td>76.7%</td>
<td>51.7%</td>
</tr>
<tr>
<td>GBP</td>
<td>10.5%</td>
<td>2.3%</td>
<td>3.4%</td>
<td>30.6%</td>
</tr>
<tr>
<td>USD</td>
<td>14.5%</td>
<td>0.5%</td>
<td>17.9%</td>
<td>11.2%</td>
</tr>
<tr>
<td>DKK, SEK</td>
<td>2.4%</td>
<td>0.0%</td>
<td>0.6%</td>
<td>0.8%</td>
</tr>
<tr>
<td>JPY</td>
<td>5.4%</td>
<td>0.0%</td>
<td>0.6%</td>
<td>4.9%</td>
</tr>
<tr>
<td>CHF</td>
<td>0.1%</td>
<td>0.1%</td>
<td>0.3%</td>
<td>0.0%</td>
</tr>
<tr>
<td>etc</td>
<td>1.3%</td>
<td>0.3%</td>
<td>0.3%</td>
<td>0.8%</td>
</tr>
<tr>
<td>cross-currency</td>
<td>1.8%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Which underlying?
In the US market, US originated debt accounts for nearly all the repo market. Again, Europe is more varied:

<table>
<thead>
<tr>
<th></th>
<th>June 2014</th>
<th>December 2013</th>
<th>June 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>19.1%</td>
<td>21.9%</td>
<td>21.9%</td>
</tr>
<tr>
<td>Italy</td>
<td>10.6%</td>
<td>9.2%</td>
<td>8.2%</td>
</tr>
<tr>
<td>France</td>
<td>10.9%</td>
<td>11.5%</td>
<td>11.7%</td>
</tr>
<tr>
<td>Belgium</td>
<td>2.9%</td>
<td>3.0%</td>
<td>3.4%</td>
</tr>
<tr>
<td>Spain</td>
<td>6.3%</td>
<td>5.2%</td>
<td>4.6%</td>
</tr>
<tr>
<td>other eurozone</td>
<td>7.3%</td>
<td>7.2%</td>
<td>8.1%</td>
</tr>
<tr>
<td>UK</td>
<td>10.6%</td>
<td>11.4%</td>
<td>12.0%</td>
</tr>
<tr>
<td>DKK, SEK</td>
<td>2.8%</td>
<td>2.8%</td>
<td>2.9%</td>
</tr>
<tr>
<td>international financial institutions</td>
<td>2.4%</td>
<td>2.7%</td>
<td>2.2%</td>
</tr>
<tr>
<td>US</td>
<td>2.6%</td>
<td>2.8%</td>
<td>2.6%</td>
</tr>
<tr>
<td>Accession countries</td>
<td>0.4%</td>
<td>0.4%</td>
<td>0.3%</td>
</tr>
<tr>
<td>Japan</td>
<td>4.8%</td>
<td>4.6%</td>
<td>4.2%</td>
</tr>
<tr>
<td>other OECD</td>
<td>11.2%</td>
<td>10.3%</td>
<td>12.1%</td>
</tr>
<tr>
<td>other fixed income</td>
<td>8.0%</td>
<td>6.6%</td>
<td>5.6%</td>
</tr>
<tr>
<td>equity</td>
<td>0.1%</td>
<td>0.3%</td>
<td>0.3%</td>
</tr>
</tbody>
</table>
# The Repo Market – Some Data cont..................

## Who, what, where, when and how?

### Underlying rating in TriParty?

<table>
<thead>
<tr>
<th>Rating</th>
<th>June 2014</th>
<th>December 2013</th>
<th>June 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>32.3%</td>
<td>36.9%</td>
<td>41.3%</td>
</tr>
<tr>
<td>AA</td>
<td>32.8%</td>
<td>29.5%</td>
<td>27.8%</td>
</tr>
<tr>
<td>A</td>
<td>8.8%</td>
<td>8.7%</td>
<td>7.4%</td>
</tr>
<tr>
<td>BBB</td>
<td>16.7%</td>
<td>14.4%</td>
<td>13.4%</td>
</tr>
<tr>
<td>below BBB-</td>
<td>3.7%</td>
<td>3.8%</td>
<td>3.5%</td>
</tr>
<tr>
<td>A1/P1</td>
<td>3.0%</td>
<td>4.8%</td>
<td>3.2%</td>
</tr>
<tr>
<td>A2/P2</td>
<td>1.6%</td>
<td>0.6%</td>
<td>1.3%</td>
</tr>
<tr>
<td>Non-Prime</td>
<td>0.4%</td>
<td>0.5%</td>
<td>0.4%</td>
</tr>
<tr>
<td>unrated</td>
<td>0.7%</td>
<td>0.8%</td>
<td>1.8%</td>
</tr>
</tbody>
</table>

### Average European TriParty haircuts?

<table>
<thead>
<tr>
<th>(weighted average haircuts)</th>
<th>June 2014</th>
<th>Dec 2013</th>
<th>June 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>government securities</td>
<td>2.5%</td>
<td>2.7%</td>
<td>2.6%</td>
</tr>
<tr>
<td>public agencies / sub-national governments</td>
<td>2.3%</td>
<td>2.3%</td>
<td>2.2%</td>
</tr>
<tr>
<td>supranational agencies</td>
<td>2.5%</td>
<td>2.5%</td>
<td>2.7%</td>
</tr>
<tr>
<td>corporate bonds (financial)</td>
<td>5.9%</td>
<td>5.8%</td>
<td>4.8%</td>
</tr>
<tr>
<td>corporate bonds (non-financial)</td>
<td>6.3%</td>
<td>6.3%</td>
<td>6.3%</td>
</tr>
<tr>
<td>covered bonds</td>
<td>2.9%</td>
<td>3.1%</td>
<td>2.8%</td>
</tr>
<tr>
<td>residential mortgage-backed</td>
<td>10.3%</td>
<td>10.9%</td>
<td>8.6%</td>
</tr>
<tr>
<td>commercial mortgage-backed</td>
<td>8.1%</td>
<td>8.2%</td>
<td>9.5%</td>
</tr>
<tr>
<td>other asset-backed</td>
<td>7.0%</td>
<td>8.0%</td>
<td>7.4%</td>
</tr>
<tr>
<td>CDO, CLN, CLO, etc</td>
<td>6.3%</td>
<td>7.1%</td>
<td>7.6%</td>
</tr>
<tr>
<td>convertible bonds</td>
<td>17.0%</td>
<td>13.1%</td>
<td>4.4%</td>
</tr>
<tr>
<td>equity</td>
<td>6.4%</td>
<td>6.0%</td>
<td>5.8%</td>
</tr>
<tr>
<td>other</td>
<td>6.7%</td>
<td>6.4%</td>
<td>3.3%</td>
</tr>
</tbody>
</table>
Regulation
Recent Developments

The use of repo is subject to a range of laws and regulations enforced by regulatory agencies. Repo is impacted both directly by laws and regulations including the Financial Stability Board’s (FSB) macro-prudential regulation and Tri-Party reform, and indirectly through regulation of the market users such as commercial banks and investment banks by banking and securities market regulators under laws and regulations implementing the Financial Transaction Tax (FTT), Leverage Ratio and other capital requirements.

Whilst we agree in principal with the ultimate aim of many of these regulations, we feel that some of them, and certainly all of them collectively are too penal and there is a real danger that the burden will be so great that it starts to increase the cost of conducting repo transactions to such a degree that market participant actively remove themselves from the market, leading to a significant reduction of liquidity and therefore a more dysfunctional market with greater volatility.

We will now look at some of the key regulations affecting the Repo Market, some of them are at the proposal/consultation phase and some have already been implemented.

Financial Transaction Tax (FTT) - Proposal

The aim is to harmonise tax treatment across the EU, have financial institutions contribute to the cost of the recent crisis and disincentivise transactions which do not enhance the efficiency of financial markets.

Repo agreements were included in the first proposal and treated as 2 separate transactions with proposed tax rates making it extremely unlikely that repo businesses would be profitable if implemented. This would result in the closing of many repo desk and incentivise the use of riskier unsecured lending and reducing the support in primary and secondary markets, especially hurting sovereign issuances. At this point it looks unlikely that repo will now be included.

Bank Levies - In place

Various countries have their own version of the Bank Levy. All are based on the B/S in some way, be it attributable assets to a certain region or total RWA. The aim is to raise tax from banks so that they contribute to the cost of the 2008 financial crisis.

Tax rates have increased significantly over the last few years meaning that the amount payable has also increased.
Regulation cont

Liquidity Coverage Ratio (LCR) - In place

The Liquidity Coverage Ratio (LCR), as part of the Basel Committee’s key reforms, aims to ensure that banks hold an adequate stock of unencumbered, high quality, liquid assets, that can be converted easily and immediately into cash to meet liquidity needs over a 30 day stress scenario.

LCR looks at the cash inflows and outflows over a 30 day period with roll off of repo transactions determined by the asset quality

The assumption is that you will always be able to fund groups higher grade collateral and so they attract no haircut. As you move down the liquidity groups, the haircut you would be charged in a stress scenario increases and so any funding < 30 days is reduced by the haircut amount.

This will force banks to fund lower category assets for >30 days via 31 day repos, extendable repos and evergreen repos.

Leverage Ratio - Proposal

The objective of the consultation phase legislation is to create a common standard for all global banking organisations regarding the leverage ratio calculation. Securities funding transactions are considered an important source of leverage and therefore are included in the leverage ratio exposure.

The legislation allows for only very limited netting having to meet the following criteria:

- Same explicit final settlement date
- Right to set off in event of default, insolvency or bankruptcy
- Intend to settle net, settle simultaneously or via a settlement mechanism that results in net settlement

There are several issues with the current methodology:

- Repos do not always have explicit final settlement dates. Consider extendable repos which will become more common as LCR is enforced
- Netting is minimal vs actual B/S netting
- It does not take into account asset quality

In order to reduce their leverage ratio, banks will wind down less profitable parts of their market making activities which could see a dramatic contraction in the repo market resulting in diminished liquidity for treasuries and other government related securities.
Regulation cont

Net Stable Funding Ratio (NSFR) - Proposal

Although the NSFR is just at the consultation phase at present, in its present form, it will have significant impacts on the repo market. Available Stable Funding (ASF) needs to be greater than Required Stable Funding (RSF) where ASF = reliable funding over 1 year and RSF is a function of liquidity characteristics and residual maturities of assets.

There is significant asymmetry between treatment of assets and liabilities if both sides are not booked with a bank. Any funding for non-bank entities attracts a 50% RSF charge, as the legislation assumes a non-bank entity is a client and we will not be able to fully cut our liquidity provision to such entities. This legislation does not take into account underlying collateral quality

There is potential for banks to stop short term trading with non-banking entities, especially on the asset side and this may cause a reallocation of this business to less-regulated, “shadow banking” areas. It hinders the transfer of secured funding between banks as well as the secured financing of the real economy. All of this will lead to volumes of secured funding >6 months will decrease significantly, accompanied by rate increases and will clearly have knock on effects for sovereign debt financing

Shadow Banking - Proposal

After feedback on it’s consultative proposals in August 2013 and results of a two-stage quantitative impact study (QIS), the FSB have published a Regulatory Framework for Haircuts on Non-centrally Cleared Securities Financing Transactions.

The Framework aims to limit the build-up of excessive leverage outside the banking system and to help reduce procyclicality of that leverage by imposing:

1. Qualitative standards for methodologies used by market participants that provide securities financing to calculate haircuts on the collateral received

2. Numerical haircut floors that will apply to non-centrally cleared securities financing transactions in which financing against collateral other than government securities is provided to entities other than banks and broker-dealers (non-banks).

This therefore exclude the bulk of Repo transaction traded in the market today. For the repo that falls under this regulation, the level of haircut floors is not excessive, indeed in general they are lower than we would already charge for these asset classes and so we expect a minimal impact on the business

Short covering is allowed via the exclusion of cash-collateralised securities lending
Regulation cont............... 

US Tri-Party Reform – In Place

In 2012, the US Tri-party Repo Infrastructure Reform Task Force released it’s final report including a 7 point roadmap to guide work required to:

1. Reduce discretionary intraday credit extended by tri-party clearing banks
2. Promote improvements in market participant’s liquidity and credit risk management practices
3. Reduce the risk of destabilising fire sales in the event of default

Much of the re-engineering to address 1 & 2 has now taken place, primarily by ending the daily unwind of cash and collateral for non-maturing trades and redesigning the process for maturing trades in a more liquidity efficient manner. Market participants have also helped by confirming their trades earlier in the day. This has resulted in a 80% reduction in intraday credit requirements, in USD terms, a reduction of $1tn.

Although Fire sale risk remains a critical policy concern of the Fed, it is not currently being addressed by industry participants and we expect to see continued pressure to do so.

Impact onRepo Market

- There has been a clear segmentation in the market between High Quality Liquid Assets (HQLA) and non-HQLA as a result of regulation such as LCR.
- This segmentation will be further defined with the shift to mandatory clearing as firms increase their demand for HQLA assets in order to post as margin for their derivative transactions
- We expect to see a shift towards longer maturity repos with an increase in non-vanilla repo transactions such as Extendable and Evergreen in order to ensure firms are LCR compliant
- This shift in demand should cause a steepening of the curve beyond 1 month and we would expect bid-offer spreads to widen, especially on the non-HQLA assets which will now need to be funded term
- Opportunities for trades such as collateral switches will also increase